**DIRECT TESTIMONY OF**

**ZACHARY J. PAYNE**

**ON BEHALF OF**

**THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF**

**DOCKET NO. 2018-318-E**

**IN RE: APPLICATION OF DUKE ENERGY PROGRESS, LLC FOR ADJUSTMENTS IN ELECTRIC RATE SCHEDULES AND TARIFFS AND REQUEST FOR AN ACCOUNTING ORDER**

**Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND OCCUPATION.**

**A.** My name is Zachary J. Payne. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina, 29201. I am employed by the South Carolina Office of Regulatory Staff ("ORS") in the Audit Department as a Senior Auditor.

**Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND YOUR BUSINESS EXPERIENCE.**

**A.** I received a Bachelor of Science Degree in Business Administration with a double major in Accounting and Economics from the University of South Carolina in May 2013. I began employment with ORS in March 2015 and since have worked on cases dealing with the regulation of nuclear waste, natural gas, water and wastewater companies.

**Q. WHAT IS THE MISSION OF THE OFFICE OF REGULATORY STAFF?**

**A.** ORS represents the public interest as defined by the South Carolina General Assembly as:

> The concerns of the using and consuming public with respect to public utility services, regardless of the class of customer, and preservation of

> continued investment in and maintenance of utility facilities so as to provide reliable and high-quality utility services.

**Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS PROCEEDING?**

**A.** The purpose of my testimony is to set forth ORS's findings and recommendations for certain adjustments resulting from ORS's examination of the application of Duke Energy Progress, LLC ("Company" or "DEP"), in Docket No. 2018-318-E. Specifically I will be addressing ORS's findings and recommendations for Company Adjustments 17, 18, 19, 30, and 35, all of which are related to accounting deferrals. These findings and recommendations are explained in detail in my testimony.

**Q. PLEASE OUTLINE THE FUNCTION OF AN ACCOUNTING ORDER TO DEFER COSTS.**

**A.** An accounting order to defer costs is a regulatory instrument in which the regulatory commission issues an order at the utility's request to establish a regulatory asset (or liability) account into which certain costs can be deferred. The ~~Governmental~~ Financial Accounting Standards Board's ("F~~G~~ASB") ~~statement No. 62~~ASC 980 provides, among other things, general standards of accounting for ~~the effects of regulation and~~regulated operations, ASC 980-340-25-1 specifically states that:

> An entity shall ~~regulated business-type activity should~~ capitalize all or part of an incurred cost that ~~otherwise would~~would otherwise be charged to expense if both of the following criteria are met:
>
> a. It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
>
> b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

In other words, F~~G~~ASB identifies the key criteria the utility must meet to capitalize costs through an approved regulatory asset as:

1) the incurred costs are likely to be recoverable for ratemaking purposes; and,
2) the costs have already been incurred, and the costs are not similar to costs the utility may incur in the future.

~~GASB statement No. 62 also indicates the utility should accrue “carrying charges” on the regulatory asset:~~

> ~~During the period between the date on which the new asset is recognized and the date on which recovery begins, the carrying amount should be increased by accruing a carrying charge.~~

F~~G~~ASB outlines the accounting standards for deferring costs; however, it is ultimately the regulatory commission that determines what costs in the regulatory asset are allowable for ratemaking purposes, and the manner in which the utility is allowed to recover the allowable costs in the regulatory asset.

Once an accounting order is issued by the regulatory commission, the utility will create a regulatory asset account on its balance sheet and record costs to the regulatory asset as the costs are incurred. The utility will request to recover regulatory assets in a future general rate case proceeding. It is during the general rate case proceeding the regulatory commission will determine the appropriate amount of allowable costs to be recovered from customers, and the manner in which the utility is allowed to recover allowable costs. Accounting orders are used by a utility to smooth earnings and rate recovery related to significant costs that arise from circumstances that are unexpected and/or non-recurring.

**Q. WILL ORS REQUEST THE COMMISSION CONSIDER GUIDELINES FOR FUTURE DEFERRAL REQUESTS?**

**A.** Yes. In Docket No. 2018-206-E, Duke Energy Carolinas, LLC, DEP, (collectively "the Companies") and ORS discussed the Companies' request for approval of an accounting order to defer certain capital and operating expenses pursuant to S.C. Code Ann. § 58-27-1540 and S.C. Code Regs. 103-825 related to the Power/Forward Initiative. On September 4, 2018, ORS filed a letter in the docket to inform the Commission that ORS would make a future filing in 2019 to request a proceeding to adopt guidelines on future deferral requests. In Commission Order No. 2018-751 the Commission adopted ORS's proposed conditions on this matter. ORS intends to make such a filing no later than December 2019.[1]

**Q. PLEASE SUMMARIZE ORS'S RECOMMENDATIONS FOR THE TREATMENT OF ACCOUNTING DEFERRALS PROPOSED BY THE COMPANY.**

**A.** ORS reviewed each of the Company's proposals for recovery of accounting deferrals and has developed a recommendation to be applied to the requests by the Company to recover its deferred costs. In most of the Company's deferrals the Company calculated a weighted average cost of capital ("WACC") return on deferred costs. Additionally, the Company proposed to include the unamortized balance of most of the deferrals in rate base. ORS recommends each deferral balance be separated into two categories of costs: operating-related costs and capital related costs. ORS recommends the recovery of both the operating-related costs and the capital-related costs be subject to the same regulatory accounting treatment required for each category absent an accounting deferral. According to the National Association of Regulatory Utility Commissioners ("NARUC") Rate Case and Audit Manual, regulatory assets and other deferrals should be examined to determine if the deferred costs are appropriate to be included in rate base. The Company may recover prudently incurred

[1] https://dms.psc.sc.gov/Attachments/Matter/36a3a7be-111b-4103-8131-bd54da3ec5de

operating expenses, without a WACC return or rate base treatment. The Company may recover prudently incurred capital costs by recording capital costs to rate base and recovering those costs through depreciation expense over the life of the associated asset, while earning a WACC return on the undepreciated balance. With the exception of deferred environmental costs in Adjustment #18, which is discussed later in my testimony, the ORS recommendations allow the Company to fully recover its actual deferred expenses. ORS's recommendations focus on how those costs should be recovered. ORS's recommendations are in the public interest because the recommendations allow for a return of costs and, where it is appropriate, a return on costs.

**Q. PLEASE EXPLAIN ORS'S RECOMMENDED ADJUSTMENTS.**

**A.** Explanations of the accounting and pro forma adjustments are presented on a South Carolina retail basis for both ORS and the Company. As shown on Audit Exhibit KLM-2, the ORS adjustment numbers are the same as those filed by the Company in its Application. My recommended adjustments for accounting deferrals are as follows:

<u>Adjustment #17 – Adjust For Previously Deferred Amounts – Harris COLA, Fukushima/Cybersecurity, 2014 Storms, and GridSouth</u>

The Company proposes to adjust depreciation and amortization expense by $3,184,000, income taxes by ($794,000), working capital investment by ($15,754,000), and accumulated deferred taxes by $3,931,000 to amortize previously deferred costs related to Harris COLA, Fukushima/Cybersecurity, 2014 Storms, and GridSouth. ORS proposes to adjust depreciation and amortization expense by $2,634,000, income taxes by ($657,000), working capital investment by ($23,118,000), and accumulated deferred taxes by $5,768,000 to amortize previously deferred costs related to Harris COLA, Fukushima/Cybersecurity, 2014 Storms, and GridSouth. Each deferral is discussed in detail below.

Harris COLA Deferral - Commission Order No. 2014-138 granted the Company's request for an accounting order to defer "certain costs incurred in connection with the development of proposed Units 2 and 3 of the Shearon Harris Nuclear Station." The Commission order also stated "(g)ranting the deferrals will not preclude this commission or any party from addressing the reasonableness of the costs deferred in regulatory asset and liability accounts in the next general rate proceeding." The Company provided ORS with support for a Harris COLA deferral balance of $6,715,000. The Company proposes amortizing the deferral balance over a five year period. The Company has not proposed to include the unamortized deferral balance in rate base.

ORS agrees with the deferral balance of $6,715,000, and proposal to exclude the unamortized deferral balance from rate base. However, ORS disagrees with the Company's proposal to amortize the deferral balance over a five year period. ORS recommends the deferral balance be amortized over an eight year period. ORS's recommendation to amortize the deferral balance over an eight year period is reasonable because it matches the time period the Company incurred and deferred the costs which was from 2006 to 2013.

Fukushima/Cybersecurity Deferral - Commission Order No. 2014-138 also granted the Company's request for an accounting order to defer "the incremental Operating & Maintenance (O&M) expenses that will be incurred as a result of complying with existing and future requirements promulgated by the Nuclear Regulatory Commission ("NRC") in response to the events at the Fukushima Daiichi Nuclear Power Station in Japan and the incremental O&M expenses that will be incurred to comply with cybersecurity regulations mandated by the NRC." The Commission order also stated "(g)ranting the deferrals will not preclude this commission or any party from addressing the reasonableness of the costs deferred in regulatory asset and liability accounts in the next general rate proceeding." The Company provided ORS with support for a Fukushima/Cybersecurity deferral balance of $5,541,000, consisting of a December 31, 2017 balance of $4,729,000, actual costs to defer during the 2018 year of $324,000, projected costs to defer between January 1, 2019 to May 30, 2019 of $242,000, and a 2018 correction to the 2017 balance of $246,000. The Company proposes to amortize the deferral balance over a five year period. The Company's application per book rate base includes the $4,729,000 December 31, 2017 deferral balance. The Company proposes to include the additional deferred amounts, less one full year of amortization in rate base.

ORS proposes a Fukushima/Cybersecurity deferral balance of $5,299,000 which will provide the Company a recovery of actual deferred costs as of December 31, 2018 including the 2018 correction to the 2017 balance. ORS recommends the Commission approve the five year amortization period for the deferral balance proposed by the Company. ORS does not recommend the deferral balance include projected costs because projected costs are not known and measurable. ORS recommends the December 31, 2017 deferral balance be removed from the Company's rate base since the balance consists of deferred O&M expense. Likewise, ORS recommends the remaining deferral balance be excluded from rate base because it consists of deferred O&M expense. ORS's recommendation to remove and exclude the actual deferred O&M expense from rate base is consistent with regulatory accounting practices for operating-related costs. ORS's recommendation allows the Company to recover its actual deferred costs through amortization of the proposed deferral balance which is a sufficient level of cost recovery. If the Company is allowed to include deferred O&M expenses in rate base, the Company will earn a return on its O&M expenses.

GridSouth Deferral – On April 12, 2001 DEP (formerly Carolina Power & Light Company) was party to a joint application filed with the Commission for authority to transfer functional control of transmission assets to GridSouth Transco, LLC under Docket No. 2001-139-E. On February 19, 2002, the joint applicants filed a notice of withdrawal of the application. The Company incurred costs totaling $3,676,000, which it deferred to an account in its rate base, as a result of the initial application. The Company proposes to recover these costs by amortizing this deferral balance over a five year period.

ORS agrees with the proposed deferral balance of $3,676,000, and the Company's proposed five year amortization period. ORS recommends removing the deferral balance from the Company's rate base as the costs are not capital expenditures. ORS's recommendation to remove the deferred expenses from rate base is consistent with regulatory accounting practices for operating-related costs. ORS's recommendation allows the Company to recover its actual deferred costs through amortization of the proposed deferral balance which is a sufficient level of cost recovery. If the Company is allowed to include deferred non-capital expenses in rate base, the Company will earn a return on non-capital expenses in excess of what it has already earned since its last general rate case.

2014 Storm Costs Deferral – Commission Order No. 2015-62 granted the Company's request "for an Accounting Order to Defer Storm Damage Expenses incurred as a result of snow and ice storms in 2014. The Company incurred $14.8 million in incremental operating and maintenance expenses to repair and restore its South Carolina system." The Company has since carried the deferral balance in a regulatory asset account as part of its rate base. As stated in Company witness Laura Bateman's testimony, "(t)his adjustment removes the South Carolina retail deferred balance from rate base, The Company is instead requesting to accrue a return on the deferred balance while it explores alternative cost recovery options for the significant storm costs incurred by the Company over the last five years."

ORS agrees with the Company's proposed treatment to remove the deferral balance from rate base. ~~ORS also agrees with the Company's proposal to accrue a return on the balance as GASB Statement 62 directs regulated businesses such as the Company to accrue a carrying charge on deferred cost regulatory assets from the time the assets are created until recovery of the asset begins.~~ ORS reserves its rights to address the reasonableness of the costs deferred in the regulatory asset account in the next general rate proceeding.

Adjustment #18 – Amortize Deferred Environmental Costs

The Company proposes to adjust depreciation and amortization expense by $10,080,000, income taxes by ($2,515,000), working capital investment by $40,322,000, and accumulated deferred taxes by ($10,060,000) to amortize the deferred environmental costs. ORS proposes to adjust depreciation and amortization expense by $597,000, income taxes by ($149,000), working capital investment by $2,160,000, and accumulated deferred taxes by ($539,000) to amortize the deferred environmental costs.

Commission Order No. 2016-490 granted the Company's request "for an accounting order authorizing the deferment of certain costs incurred in connection with complying with federal and state environmental remediation requirements related to permanently closing coal ash basins and other ash storage units at the Companies' coal fired generating facilities." The Commission order also stated "This ruling in no way limits the ability to challenge the reasonableness of these expenditures in a subsequent general rate case or other proceeding."

The Company provided ORS with support for a deferral balance of $50,402,000 consisting of $50,740,000 in deferred asset retirement obligation ("ARO") plant spend, ($5,062,000) in offsets from the nuclear decommissioning trust fund ("NDTF") overcollection and retired and active plant cost of removal collections, $5,150,000 in after-tax WACC return on the ARO plant balance, ($1,517,000) for an Ashville prudence disallowance, $764,000 for a WACC return on the non-ARO plant balance, $307,000 for deferred depreciation of the non-ARO plant balance, and $20,000 for an after-tax return on the deferred non-ARO costs. The Company proposes amortizing this deferral balance over a five year period, and including the balance less one year of amortization in rate base.

ORS proposes a deferral balance of $2,984,000 which includes $8,484,000 in deferred ARO plant spend, ($5,062,000) in in offsets from the NDTF overcollection and retired and active plant cost of removal collections, $299,000 in after-tax WACC return on the ARO plant balance, ($1,517,000) for an Ashville prudence disallowance, $553,000 for a WACC return on the non-ARO plant balance, and $227,000 for deferred depreciation of the non-ARO plant balance. ORS proposes including in rate base all components of the deferral balance (less one year of amortization) except for the deferred depreciation of the non-ARO plant balance. ORS's recommendation to include the deferred capital costs portion of the deferral in rate base, and exclude the deferred depreciation expense from rate base is consistent with regulatory accounting practices for capital-related and operating-related costs.

ORS calculated its proposed deferral balance starting with the disallowed ARO system expenditure through September 30, 2018, provided in the testimony of ORS witness Dan Wittliff. The ORS Audit Department calculated an allowable percentage per month based on Mr. Wittliff's recommended total amount and applied that percentage to the ARO monthly expenditures that were originally provided by the Company. Creating an allowable monthly expense allocation was necessary to calculate the WACC return in a manner consistent with the Company's original calculation. ORS then added the non-ARO WACC return and deferred depreciation expense to the allowable ARO plant spend, less NDTF overcollection, plus WACC return on the allowable plant balance. ORS does not recommend the Commission adopt the Company's calculation of a WACC return on the non-ARO deferred cost of capital and deferred depreciation expense. ORS did not include such a return in the proposed deferral balance. If the Company is allowed to include depreciation expense in rate base, the Company will earn a return on these expenses.

<u>Adjustment #19 – Amortize Deferred Cost Balance Related to South Carolina Advanced Metering Infrastructure ("SC AMI")</u>

The Company proposes to adjust depreciation and amortization expense by $468,000, income taxes by ($117,000), working capital investment by $935,000, and accumulated deferred taxes by ($233,000) to amortize the deferred cost balance related to SC AMI. ORS proposes to adjust depreciation and amortization expense by $104,000, income taxes by ($26,000), working capital investment by $861,000, and accumulated deferred taxes by ($215,000) to amortize the deferred cost balance related to SC AMI.

Commission Order No. 2018-553 granted the Company's request "to defer (1) the incremental O&M expense and depreciation expense, associated with the AMI, as well as the carrying cost on the investment and on the deferred costs at its weighted average cost of capital" The Commission order also stated that "(t)he Company further maintains that the issuance of the requested accounting order will not prejudice the right of any party to address the prudency of costs in a subsequent general rate case proceeding." The Company provided ORS with support for a deferral balance of $1,403,000 consisting of $802,000 in deferred cost of capital, $560,000 in deferred depreciation expense, and $41,000 in after-tax return on deferred costs. The Company proposes amortizing this deferral balance over a three year period, and including the balance less one year of amortization in rate base.

ORS proposes a deferral balance of $1,562,000 which will provide the Company a recovery of the same deferred cost of capital and deferred depreciation expense as the Company's proposal, but does not include a return on those deferred costs. ORS recommends the deferred cost of capital portion of the deferral balance be included in rate base. ORS does not recommend that the deferred depreciation expense portion of the deferral balance be included in rate base. ORS's recommendation to include the deferred cost of capital portion of the deferral in rate base, and exclude the deferred depreciation expense from rate base is consistent with regulatory accounting practices for capital-related and operating-related costs. ORS's recommendation still allows the Company to recover its actual deferred costs through amortization of the proposed deferral balance which is a sufficient level of cost recovery. If the Company is allowed to include depreciation expense in rate base, the Company will earn a return on its depreciation expense.

ORS proposes amortizing the deferral balance over a period of 15 years. This amortization period was provided by the ORS Utility Rates Department, and is addressed in more detail in the testimony of ORS witness Willie Morgan.

<u>Adjustment #30 – Adjust for Customer Connect Additional Expense and Deferral</u>

The Company proposes to adjust other O&M by $1,227,000, depreciation and amortization expense by $515,000, income taxes by ($435,000), working capital investment by $1,029,000, and accumulated deferred taxes by ($257,000) to adjust for Customer Connect additional expenses and to amortize deferred costs. ORS proposes to adjust depreciation and amortization expense by $308,000 and income taxes by ($77,000) to adjust for the amortization of deferred costs related to Customer Connect.

Commission Order No. 2018-553 granted the Company's request to defer "incremental O&M expenses associated with the deployment of the Customer Connect program as well as the carrying cost on the deferred costs at its weighted average cost of capital" The Commission order also stated "(t)he Company further maintains that the issuance of the requested accounting order will not prejudice the right of any party to address the prudency of costs in a subsequent general rate case proceeding." The Company provided ORS with support for a deferral balance of $1,544,000 consisting of $718,000 in actual deferred O&M expenditures as of September 30, 2018, $759,000 in estimated deferred O&M expenditures between October 1, 2018 and May 31, 2019, and a calculated weighted average cost of capital return of $67,000. The Company proposes amortizing this deferral balance over a three year period, and including the balance less one year of amortization in rate base.

Additionally, the Company proposes adjusting other O&M expense by $1,227,000. This adjustment represents the difference between the Company's actual test year O&M expense attributable to the Customer Connect project of $160,000, and the Company's projected average annual O&M expense of $1,387,000 during the 2019 and 2020 years.

ORS proposes a deferral balance of $923,000 which consists of the Company's actual deferred O&M expenditures as of December 31, 2018. ORS does not recommend including the Company's estimated O&M expenditures in the deferral balance as they are not known and measurable. ORS does not recommend a return on any deferred expenses, and ORS does not recommend that any of the deferral balance be included in rate base since the balance consists entirely of deferred O&M expense. ORS's recommendation to exclude the actual deferred O&M expense from rate base is consistent with regulatory accounting practices for operating-related costs. ORS's recommendation still allows the Company to recover its actual deferred costs through amortization of the proposed deferral balance which is a sufficient level of cost recovery. If the Company is allowed to include deferred O&M expenses in rate base, the Company will earn a return on its O&M expenses.

The Company proposes to increase other O&M expense by $1,227,000 which the Company identified as an estimate. The Company should not be allowed to recover estimated or projected O&M expenditures as they are not known and measurable. The Company recorded $160,000 in actual O&M expense during the test year attributed to the Customer Connect project and ORS recommends approval of these known and measurable expenses.

Adjustment #35 – Amortize Deferred Cost Balance Related to South Carolina Grid

The Company proposes to adjust depreciation and amortization expense by $1,164,000, income taxes by ($291,000), working capital investment by $1,164,000, and accumulated deferred taxes by ($291,000) to amortize the deferred cost balance related to SC grid. ORS proposes to adjust depreciation and amortization expense by $424,000, income taxes by ($106,000), working capital investment by $1,016,000, and accumulated deferred taxes by ($253,000) to amortize the deferred cost balance related to South Carolina grid.

Commission Order No. 2018-751 granted the Company's request "to defer the incremental Operating and Maintenance ("OAM"), depreciation and property taxes associated with certain capital assets installed as part of its Power/Forward work, as well as the carrying cost on the investment and on the deferred costs at each utility's weighted average cost of capital." The Commission order also stated "the issuance of the requested accounting order would not prejudice the right of any party to address the prudency of these costs in the Companies' next general rate case proceeding." The Company provided ORS with support for a deferral balance of $2,329,000 consisting of $1,266,000 in deferred cost of capital, $979,000 in deferred depreciation, O&M, and property tax expenses, and $84,000 in after-tax return on deferred costs. The Company proposes amortizing this deferral balance over a two year period, and including the balance less one year of amortization in rate base.

ORS proposes a deferral balance of $2,118,000 which will provide the Company a recovery of the same deferred cost of capital, deferred depreciation, deferred O&M, and deferred property tax expenses as the Company's proposal, but does not include a return on those deferred costs. ORS recommends the deferred cost of capital portion of the deferral balance be included in rate base. ORS does not recommend that the deferred depreciation, O&M, and property tax expense portion of the deferral balance be included in rate base. ORS's recommendation to include the deferred cost of capital portion of the deferral in rate base, and exclude the deferred depreciation, O&M, and property tax expenses from rate base is consistent with regulatory accounting practices for capital-related and operating-related costs. ORS's recommendation still allows the Company to recover its actual deferred costs through amortization of the proposed deferral balance which is a sufficient level of cost recovery. If the Company is allowed to include depreciation, O&M, and property tax expense in rate base, the Company will earn a return on these expenses.

ORS proposes amortizing the deferral balance over a period of 5 years. This amortization period was provided by the ORS Utility Rates Department, and is addressed in more detail in the testimony of ORS witness Anthony Sandonato.

**Q. WILL YOU UPDATE YOUR TESTIMONY BASED ON INFORMATION THAT BECOMES AVAILABLE?**

**A.** Yes. ORS fully reserves the right to revise its recommendations via supplemental testimony should new information become available not previously provided by the Company.

**Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

**A.** Yes, it does.